IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A.D. 1976

No. 76-1082

IN THE MATTER OF:

MEREDOSIA HARBOR & FLEETING SERVICE, INC., and RIVER ROAD MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA,

Petitioner,

v.

ROBERT M. MAGILL,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

DUANE D. YOUNG
1027 South Second Street
P.O. Box 458
Springfield, Illinois 62705
Attorney for Petitioners

SCHNEPP & BARNES PRINTERS, INC., SPRINGFIELD, ILL.

INDEX

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A.D. 1976

No.

IN THE MATTER OF:

MEREDOSIA HARBOR & FLEETING SERVICE, INC., and RIVER ROAD MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA,

Petitioner,

v.

ROBERT M. MAGILL,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

a. THIS CASE IS REPORTED IN: 545 F. 2d 583 (1976).

b. GROUNDS FOR JURISDICTION:

i. The date of judgment: November 8, 1976.

ii. Stay of Mandate denied, Court of Appeals, December 2, 1976; Application for Stay of Mandate, United States Supreme Court, denied, December 10, 1976, No. A-476.

iii. Statutory provisions conferring jurisdiction: Section 1254(1) of Title 28, United States Code.

c. JURISDICTION OF FEDERAL COURT IN FIRST INSTANCE: Article III, Section 2, United States Constitution; §1334, Title 28, United States Code.

d. QUESTIONS PRESENTED FOR REVIEW:

1. Is "good faith in fact" a requirement of ¶922(a)(3) of Title 46, United States Code?

2. Where a full and fair consideration is given by a Mortgagee of a Preferred Ships Mortgage, may the Mortgagee be charged with the bad faith of the Mortgagor, where the affidavit required by ¶922(a)(3) of Title 46, United States Code, is made by the Mortgagor?

e. STATUTES INVOLVED:

i. Section 922(a) and (b), Title 46, United States Code, (41 Stat. 1000; 49 Stat. 424; 75 Stat. 661)

Preferred Mortgages

"(a) A valid mortgage which at the time it is made, includes the whole of any vessel of the United States (other than a towboat, barge, scow, lighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons), shall, in addition, have, in respect to such vessel and as of the date of the compliance with all the provisions of this subsection, the preferred status given by the provisions of section 953 of this title, if —

(1) The mortgage is endorsed upon the vessel's documents in accordance with the provisions of this section;

(2) The mortgage is recorded as provided in section 921 of this title, together with the time and date when the mortgage is so endorsed;

(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made

in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel;

(4) The mortgage does not stipulate that the mortgagee waives the preferred status thereof; and

(5) The mortgagee is a citizen of the United States and for the purposes of this section the Reconstruction Finance Corporation shall, in addition to those designated in sections 888 and 802 of this title, be deemed a citizen of the United States.

"(b) Any mortgage which complies in respect to any vessel with the conditions enumerated in this section is hereafter in this chapter called a 'preferred mortgage' as to such vessel." . . .

ii. Section 953, Title 46, United States Code, (41 Stat. 1004):

Preferred maritime lien; priorities; other liens

"(a) When used hereinafter in this chapter, the term 'preferred maritime lien' means (1) a lien arising prior in time to the recording and indorsement of a preferred mortgage in accordance with the provisions of this chapter; or (2) a lien for damages arising out of tort, for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel, for wages of the crew of the vessel, for general average, and for salvage, including contract salvage.

"(b) Upon the sale of any mortgaged vessel by order of a district court of the United States in any suit in rem in admiralty for the enforcement of a preferred mortgage lien thereon, all preexisting claims in the vessel, including any possessory common-law lien of which a lienor is deprived under the provisions of

section 952 of this title, shall be held terminated and shall thereafter attach, in like amount and in accordance with their respective priorities, to the proceeds of the sale; except that the preferred mortgage lien shall have priority over all claims against the vessel, except (1) preferred maritime liens, and (2) expenses and fees allowed and costs taxed, by the court."

iii. Section 60(a) and (b) of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b) (reproduced in pertinent part):

Preferred creditors

"(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

• • •

"(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: Provided however, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in

which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

e. STATEMENT OF THE CASE:

This action was brought by the Petitioner as holder of the Preferred Ships Mortgage taken by the Petitioner on October 1, 1970 to secure advances made by the Petitioner Bank to the owner of the vessels upon which the Mortgage was taken. These advances were made to the owner of the vessels by withdrawals by the owner from a bank account at the Petitioner Bank and on uncollected funds which were subsequently dishonored by various drawee banks, resulting in overdrafts in the owner's bank account. These overdrafts developed eleven to twenty-one days prior to the taking of the Mortgage by the Petitioner. In all, the Petitioner advanced to the vessel owner the sum of $170,000 and the Schuyler State Bank of Rushville advanced the amount of $130,000, for a total of $300,000, which amount was secured by the subject Preferred Ships Mortgage. For purposes of this case, and as disclosed by the record throughout, Petitioner herein in subrogated to the entire claim of the Schuyler State Bank. The trial court found the advance of $300,000 to the vessel owner to be the result of a "check kiting scheme." There is no dispute that the Mortgagees suffered losses in the amount of $300,000.

Reclamation Petitions were filed in the Bankruptcy Court seeking a recovery of the vessels, or in the alternative, the proceeds from the sale of the vessels. The Reclamation Petitions were based upon the subject Preferred Ships Mortgages held by the Petitioner. The Trustee filed

an Affirmative Defense in the nature of an action brought pursuant to §60 of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b), to set aside the Mortgage as a preferential transfer.

At trial, the Petitioner raised as a defense, *inter alia*, that a Mortgage perfected by compliance with §922 of the Ships Mortgage Act, Title 46, United States Code, §922, is an allowable preference and intended by the Congress to be unassailable under §60 of the Bankruptcy Act, and further, that the properly perfected Preferred Ships Mortgage is entitled to the priority set out in §953 of the Ships Mortgage Act, Title 46, United States Code, §953.

The Bankruptcy Court found the Mortgage void. On Appeal, the United States District Court found the Mortgage voidable and properly set aside as a preferential transfer under §60 of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b). An Appeal was taken to the United States Court of Appeals for the Seventh Circuit and a copy of the Court of Appeals' Opinion is hereinafter reproduced. The Court of Appeals found the Preferred Ships Mortgage vulnerable by an inquiry made into the Affidavit made in compliance with §922(a)(3) of the United States Shipping Act; more particularly, good faith in fact was held required and chargeable to the Mortgagee even though the Mortgagor had made the required Affidavit.

ARGUMENT

The lien of a Preferred Ships Mortgage may not be set aside, or its preferred status impaired, by an inquiry behind an affidavit filed in conformity with §922(a)(3) of the Ships Mortgage Act; an affidavit made in bad faith by the Mortgagor may not be charged to the Preferred Ships Mortgagee, where the Mortgagee has paid a full and fair consideration.

The Court of Appeals held that §922(a)(3) of Title 46, United States Code, "demands assurance that 'the mortgage is made in good faith'." The subsection reads that the mortgage shall have the preferred status given by §953 of Title 46, United States Code, if, *inter alia*:

> "(3) an affidavit is *filed* . . . to the effect that the mortgage is made in good faith . . . ." (emphasis added)

The obvious purpose of the affidavit is to provide an alternative recourse to other creditors of a mortgagor who makes a Preferred Ships Mortgage in bad faith and with the intent to defraud other creditors. Such alternative recourse is necessary because the Preferred Ships Mortgage was intended by the Congress to be unassailable if the requirements of §922(a) are met. The Congress' intentions are succinctly summarized in Gilmore & Black, *The Law of Admiralty*, §9-48:

> "In considering the mechanics of getting rid of the wartime fleet, the Congressional committees soon realized that large infusions of new capital would have to be pumped into the long moribund private shipping industry. That meant credit and the credit would have to come from the Government or the banks or both. In either case the lender would demand satisfactory security. Recognizing that much of the financing would

have to be done by the Government, but hoping that private capital could be induced to take its share, Congress incorporated in the Shipping Act of 1920 a statute to be known as the Ship Mortgage Act, whose purpose was to make private investment in shipping attractive as well as to protect the United States which would obviously be the principal source of credit."

The efficacy of the Preferred Ships Mortgage was before this Honorable Court in *Detroit Trust Co. v. The Barlum*, 293 U.S. 21, 38, 55 S.Ct. 31, 79 L.Ed. 176 (1934):

> "Such a mortgage upon a vessel documented under the laws of the United States, the Congress has undertaken to regulate with respect to priority of lien. If the conditions so laid down are fulfilled, the mortgage is to be a 'preferred mortgage' with all the incidents which the Act attaches to it, including the right to bring foreclosure in admiralty. *To hold that a mortgage is not within the Act which the Act itself states is within it, is not to construe the Act but amend it.* The question of policy—whether different terms should have been imposed — is not for us. We may not add to the conditions set up by Congress any more than we can subtract from them. They stand as defined, precise and complete." (Emphasis added.)

The Court in *Barlum* was faced with the question of the application of ships mortgage loan proceeds. Compelling and salient observations were made:

> "An examination of the provisions of the Act leaves no doubt that the subject of mortgages of vessels, and, in particular, the priority which should be assigned them in relation to other liens, was under the close scrutiny of the Congress in determining its policy. But, among all the minute requirements of the Act, we find none as to the application of the proceeds of loans which mortgages secure. . . . We are not at liberty to imply a condition which is opposed to the explicit terms of the statute." 293 U.S. 21, 37-38.

Relief to the Petitioner was not only denied by the finding that the required affidavit was not, *in fact*, made in good faith, but for the further reason that the Petitioner, as Mortgagee, was charged with the affiant's wrongdoing. Petitioner suffered losses in the amount of $300,000 between September 10 and 20, 1970, only eleven to twenty-one days prior to receipt of the Mortgage by the Petitioner; consideration flowed to the Mortgagor as a result of a "check-kiting scheme." It is urged as patently unconscionable to charge the Mortgagee with bad faith for taking a Preferred Ships Mortgage on vessels sold for $45,000 to secure a loss of $300,000. That finding, on its face, has no basis in logic, reason, or fact.

The questions presented in this Petition are novel, but of great importance, which are here urged as of a character which have not, but ought be settled by this Court; Ships Mortgages are the subject of Treaties and the needs of the Maritime Commerce are succored by the intended security for investors in the shipping industry. Courts of seafaring nations throughout the world are called upon to determine the priorities of maritime liens. The decision of the Court of Appeals has armed every detractor of any Preferred Ships Mortgage with the means to strike swiftly and fatally behind the heretofore invincible shield provided by the Congress. Unless checked by this Court, an intended safeguard of the Maritime Commerce has suffered a new and far reaching vulnerability. None of the parties to this case, nor the courts below, received any guidance from any reported decision on the precise questions presented here. An important question of the intent of Congress is presented and the vulernability of Preferred Ships Mortgages everywhere is at stake. The law will otherwise be made at each trial of a Preferred Ships Mortgage, and having been made, will expire, with little or no guidance

for the wary investor. He may well be denied the security Congress intended.

CONCLUSION

Petitioner submits that the judgment of the Seventh Circuit Court of Appeals is erroneous on its face, that the requirements of §922(a)(3), Title 46, United States Code, were not construed but improperly amended by the sanction of the inquiry into the state of mind of the affiant, and further, that the conclusion of bad faith on the part of the Mortgagee/Petitioner is without foundation in law, logic, reason or fact. The decision departs from the requirements of the statute and thereby thwarts the underlying policy and rationale of the Ships Mortgage Act. The implications are momentous.

I pray this Honorable Court grant this Petition and issue a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

DUANE D. YOUNG
1027 South Second Street
P.O. Box 458
Springfield, Illinois 62705
Attorney for Petitioners

In the

United States Court of Appeals

For the Seventh Circuit

No. 76-1018

In the Matter of:

MEREDOSIA HARBOR & FLEETING SERVICE, INC. and RIVER ROAD MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA,
Lien Claimant-Appellant,

v.

ROBERT M. MAGILL,
Trustee-Appellee.

Appeal from the United States District Court for the Southern District of Illinois.
Nos. S-BK-70-1365, 1366—HARLINGTON WOOD, JR., *Judge*

ARGUED SEPTEMBER 17, 1976—DECIDED NOVEMBER 8, 1976

Before FAIRCHILD, *Chief Judge,* CUMMINGS and TONE, *Circuit Judges.*

CUMMINGS, *Circuit Judge.* This case arises from the denial of two Illinois banks' petitions to reclaim two vessels, allegedly subject to a maritime mortgage, or the proceeds from their sale in the hands of the bankruptcy trustee of the corporate mortgagor.

In 1970, John D. Rasco formed two companies, *viz.,* Meredosia Harbor & Fleeting Service, Inc. and River Road

Marine Repair, Inc., its wholly owned subsidiary, to build and repair boats. During that year, the corporations were building the *Mary Ann*, a river towboat, and the *Anita Marie*, a harbor towboat.

In early 1970, Rasco engaged upon a fraudulent scheme to obtain funds from appellant Farmers & Traders State Bank of Meredosia (Meredosia Bank) and its subrogor, Schuyler State Bank of Rushville (Rushville Bank). Rasco opened checking accounts in the corporate names and in his own name in those banks and in another Illinois bank and an Oklahoma bank. During the summer of 1970, he commenced kiting checks among the various banks. The kite was discovered by bank examiners in auditing the Meredosia Bank in early September 1970. Because of the check kite and Rasco's own unsecured borrowings on his account and on each corporation's account from the Meredosia and Rushville Banks, the Meredosia Bank lost $170,000 and the Rushville Bank $130,000.

Neither of Rasco's corporations ever had any paid-in capital, and neither issued any stock. Both corporations were insolvent in early September 1970. The Meredosia Bank was aware of Rasco's check kiting as early as July 1970, and the Rushville Bank realized in early September 1970 that Rasco was insolvent and in an overdraft position. There was evidence of connivance between some of the bank officers and Rasco.

On October 1, 1970, River Road Marine Repair, Inc., pursuant to the banks' demand, mortgaged the *Mary Ann* and the *Anita Marie* to the banks to secure the indebtedness of $300,000, consisting of $170,000 cash previously advanced by the Meredosia Bank and 130,000 cash previously advanced by the Rushville Bank. Attached to the mortgage was Rasco's October 1, 1970, affidavit stating that the mortgage was made by Rasco as president of River Road Marine Repair, Inc.,

> "in good faith without any design to hinder, delay or defraud any existing or future creditor of the mortgagor (shipowner) or any lienor of the vessel mortgaged; and that this affidavit is made pursuant to the order of the Board of Directors of said corporation."

Both vessels were incomplete on October 1.

On November 6, 1970, the mortgagor River Road Marine Repair, Inc. and Rasco's other corporation, Meredosia Harbor & Fleeting Service, Inc., filed reorganization petitions under Chapter XI of the Bankruptcy Act. On the same day, they filed petitions to consolidate their Chapter XI proceedings. Consolidation orders were entered the same day by the bankruptcy referee and Alonzo Sargent was appointed as their receiver.

On November 20, 1970, the receiver sent a notice to all the creditors listed in the debtor's schedule of creditors, fixing the time and place for the first meeting of creditors and for various subsequent hearings. As sent out, the notice specified that the last date to file claims was June 14, 1971. The final paragraph of the notice referred to the fact that River Road Marine Repair, Inc.'s petition for arrangement had been consolidated with that of Meredosia Harbor & Fleeting Service, Inc. and that the cases were to proceed under one title, *viz.*, In the Matter of Meredosia Harbor & Fleeting Service, Inc., No. S-BK-70-1365. The receiver's summary of liabilities and assets of the consolidated debtors attached to the notice unrealistically valued the *Mary Ann* at 450,000 and the *Anita Marie* at $135,000. The debtors' personal property schedule filed by Rasco on December 14, 1970, listed the *Mary Ann's* incomplete value as "unknown" and the *Anita Marie's* incomplete value as $80,000. Rasco listed corporate debts of $504,350.08 and $59,132.65, or a grand total of $563,482.73.

In the consolidated proceeding, an adjudication of bankruptcy was entered on January 4, 1971, and receiver Sargent was appointed as trustee. Ten days thereafter, the trustee petitioned for leave to sell both unfinished vessels and other property of the consolidated bankrupts. On the following day, the referee in bankruptcy sent a notice to the creditors to show on or before January 25, 1971, why the

property should not be sold. On June 25, 1971, he authorized the sale of the bankrupts' property, there having been no contest to the January 15 show cause order. On December 14, 1971, he approved the trustee's sale of the *Anita Marie* for $21,500. A month thereafter, he approved the sale of the *Mary Ann* and other miscellaneous personal property of the bankrupt for $25,000.

On February 7, 1973, the Meredosia Bank filed an objection to the trustee's January 2, 1973, final report, indicating that it had a maritime mortgage for the two vessels for $300,000, and stating that the trustee's counsel had previously advised the bank that the proceeds of the sale of the two vessels would not be expended until it was determined whether the mortgage was a valid lien. In March 1973, the Meredosia Bank filed a petition to reclaim the vessels or the proceeds of their sale, and a similar reclamation petition was filed in June 1973 by the Rushville Bank.

On May 1, 1974, the bankruptcy referee overruled the Meredosia Bank's objections to the final account of the trustee[1] and denied both banks' reclamation petitions. At the same time, he entered supporting findings of fact, conclusions of law and an opinion. In his opinion, the referee noted that the October 1, 1970, mortgage was given for an antecedent debt of $300,000 caused by Rasco's check-kiting scheme. He observed that the bankrupts were hopelessly insolvent at the time of the mortgage transaction. He held that the mortgage on the towboats was void as a preference. He also held that the mortgage was invalid for want of a proper supporting affidavit and because each boat was incomplete when the mortgage was executed. Consequently, both banks' claims were only allowed as general claims.

On October 23, 1975, the district court rendered a thorough opinion affirming the referee's order. Judge Wood held that the banks never possessed a valid preferred

[1] On May 30, 1972, the referee appointed Robert M. Magill as successor trustee to the late Alonzo Sargent.

ship's mortgage because the supporting affidavit was not made in good faith. He also held that the banks had only a voidable preference because they had reasonable cause to believe that the mortgagor River Road Marine Repair, Inc. was insolvent at the time of the mortgage. Other contentions of the banks were overruled. We affirm.

The Meredosia bank insists that the bankruptcy court had no jurisdiction to consider the preferred mortgage the banks assertedly obtained on the two vessels under the Ship's Mortgage Act of 1920 (46 U.S.C. § 911 *et seq.*). The bank maintains that only a federal district court, a court with original jurisdiction in admiralty, may question the validity of a preferred ship's mortgage.[2] However, in the consolidated proceedings involving the mortgagor River Road Marine Repair, Inc., the consolidated debtor was adjudicated bankrupt on January 4, 1971. By that act, the property of the bankrupt passed into the custody of the bankruptcy court. 2 Collier on Bankruptcy ¶ 23.04 (14th ed. 1974). Having first secured custody of the vessels, the bankruptcy court was entitled to retain possession and determine all lien claims asserted against the vessels. 1 Collier on Bankruptcy ¶ 2.10 at 180-181 (14th ed. 1974).[3] Thus the referee in bankruptcy properly reached the validity of the maritime mortgage.

[2] Since we find *infra* that the October 1 mortgage was not a preferred ship's mortgage under 46 U.S.C. § 922(a), the exclusive original jurisdiction granted to the federal district courts "[u]pon the default of any term or condition of the mortgage" under 46 U.S.C. § 951 for "preferred mortgages" is not applicable. Thus for purposes of our jurisdictional analysis, only more general maritime law principles need be examined to determine whether the bankruptcy court was ousted of its jurisdiction.

[3] Appellant argues that the lien attached to the towboats *qua* towboats and not as species of the bankrupt's property. This argument claims that since a ship and its owner are sometimes distinct juridical entities in admiralty, a bankruptcy court cannot be in constructive possession of the bankrupt's ship. Despite a penchant for esoterica in the law of admiralty, appellant's construct proves too much. Since the bankruptcy court has the power to restrain an admiralty action *in rem* against a ship in the court's control, In

(Footnote continued on following page)

An otherwise valid ship's mortgage is granted the preferred status given by 46 U.S.C. § 953[4] only if the conditions of 46 U.S.C. § 922(a)[5] are met. Here the bankruptcy court

[3] *Continued*
re *J. S. Gissel & Co.*, 238 F. Supp. 130 (S.D. Tex. 1965), the court also has power to adjudicate the status of claims before it. See generally Gilmore & Black, The Law of Admiralty 806-817 (2d ed. 1975).

[4] Section 953 provides:

"(a) When used hereinafter in this chapter, the term 'preferred maritime lien' means (1) a lien arising prior in time to the recording and indorsement of a preferred mortgage in accordance with the provisions of this chapter; or (2) a lien for damages arising out of tort, for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel, for wages of the crew of the vessel, for general average, and for salvage, including contract salvage.

"(b) Upon the sale of any mortgaged vessel by order of a district court of the United States in any suit in rem in admiralty for the enforcement of a preferred mortgage lien thereon, all preexisting claims in the vessel, including any possessory common-law lien of which a lienor is deprived under the provisions of section 952 of this title, shall be held terminated and shall thereafter attach, in like amount and in accordance with their respective priorities, to the proceeds of the sale; except that the preferred mortgage lien shall have priority over all claims against the vessel, except (1) preferred maritime liens, and (2) expenses and fees allowed and costs taxed, by the court."

[5] Section 922(a) provides:

"A valid mortgage which at the time it is made, includes the whole of any vessel of the United States (other than a towboat, barge, scow, lighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons), shall, in addition, have, in respect to such vessel and as of the date of the compliance with all the provisions of this subsection, the preferred status given by the provisions of section 953 of this title, if —

"(1) The mortgage is endorsed upon the vessel's documents in accordance with the provisions of this section;

"(2) The mortgage is recorded as provided in section 921 of this title, together with the time and date when the mortgage is so endorsed;

(Footnote continued on following page)

refused to give preferential status to the banks' maritime lien because Rasco's accompanying affidavit that the mortgage was "made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel", as required by Section 922(a)(3), was itself made in bad faith. The banks would have use construe Section 922(a)(3) in a *pro forma* manner, *viz.*: once the affidavit is made the Section's requirement is met without more. If the affidavit is fraudulent, the appellants argue that recourse should be had against the affiant rather than the mortgage. We disagree. The Section 922(a)(3) affidavit requirement demands assurance that the "mortgage is made in good faith." The good faith requirement applies to the mortgage transaction. This creates, in turn, a derivative good faith requirement for the mortgagee. Upon a showing that the mortgagee knew of the mortgagor's bad faith, such knowledge will trigger Section 922(a)(3). Since each of the requirements of Section 922(a) is independently necessary for a ship's mortgage to attain preferred status, the mortgagee's bad faith will defeat a mortgage's aspiration towards preferred status.

The district judge marshalled nine factors based on the evidence that negated this good faith requirement:

Representatives of both banks agreed on the mortgage.

At the time the mortgage was arranged, bankruptcy was contemplated by all parties.

[5] *Continued*

"(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel;

"(4) The mortgage does not stipulate that the mortgagee waives the preferred status thereof; and

"(5) The mortgagee is a citizen of the United States and for the purposes of this section the Reconstruction Finance Corporation shall, in addition to those designated in sections 888 and 802 of this title, be deemed a citizen of the United States."

The mortgage was agreed upon after the large overdraft developed.

Rasco paid off officers of both banks to help get loans approved.

As of September 1, 1970, Rasco admits his liabilities were larger than his assets.

Duesterhaus, an employee of the Bank of Meredosia in the loan department, heard of the check-kiting scheme in the latter part of September when the IRS and FBI conducted an investigation.

Duesterhaus notified Thormahlen and Westphal (President and Vice President of the Bank of Meredosia) as to the overdraft. They replied that Westphal knew what was going on.

Pezman, Chairman of the Board of Schuyler State Bank, first questioned the solvency of Rasco around September 10th or 11th and thereafter "it began to snowball."

William Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before "it broke."

In light of this evidence, the court correctly held that the ship's mortgage did not attain preferred status under Section 922(a).[4] Since the mortgage did not acquire "preferred status" under Section 922(a), the banks obtained no statutory lien on the vessels under 46 U.S.C. § 953. Therefore, Section 67(b) of the Bankruptcy Act (11 U.S.C. § 107(b)),[5] which preserves statutory liens from the void-

[4] We need not consider another reason to defeat preferred status advanced by the referee, *i.e.*, the vessels were incomplete and had fraudulent documentation when the mortgage was executed, so that the mortgage did not include "the whole of any vessel of the United States" or the documentation required by Section 922(a).

[5] Section 67(b) provides:

"The provision of section 96 of this title [Section 60 of the Bankruptcy Act] to the contrary notwithstanding, statutory

(Footnote continued on following page)

able preference provision of Section 60 (11 U.S.C. § 96), was inoperative.[6]

The trustee asserts that the bankrupt made a preferential transfer, which was voidable by the trustee under Section 60. The elements of a prima facie showing of a voidable preference under Section 60(a)(1)[7] (11 U.S.C. § 96(a)(1)) are: (1) a debtor making or suffering a transfer of his property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt thereby resulting in the depletion of the estate; (4) while insolvent; and (5) within four months of bankruptcy; (6) the effect of which transfer will be to enable the creditor to obtain

[5] *Continued*

liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this title by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of property, they shall instead be perfected by filing notice thereof with the court."

[6] The district judge also held Section 67(b) inapplicable because any lien obtained by the banks was made by agreement and therefore not a "statutory lien" as defined in Section 1.29(a) of the Bankruptcy Act (11 U.S.C. § 1.29) and as used in Section 67(b). Since the banks had obtained no valid lien on the vessels, this point need not be decided on appeal either.

[7] Section 60(a)(1) provides:

"A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

a greater percentage of his debt than some other creditors of the same class. The banks maintain that a prima facie showing of a Section 60 voidable preference has not been made on the ground that several of the required elements are not satisfied.

First, appellant argues as a matter of due process that because the towboats were owned by River Road Marine and because the caption of the bankruptcy adjudication was "Meredosia Harbor & Fleeting Service, Inc." only Meredosia was adjudicated bankrupt, so that the transfer of the boats by River Road Marine was not by the debtor. Appellant's argument has no merit. The Meredosia Bank contends that no notice of the November 6, 1970, consolidation of the two reorganization petitions was given to creditors and that therefore River Road Marine Repair, Inc., the mortgagor, cannot be deemed as having been derivatively adjudicated bankrupt. This is refuted by the record. The consolidation was at the request of each Rasco corporation. The November 20, 1970, notice to all creditors called their attention to the November 6th consolidation order and advised that both cases would proceed under the name of the parent Meredosia Harbor & Fleeting Service, Inc. Because of the consolidation, the bankruptcy adjudication of the parent on January 4, 1971, covered its wholly-owned and jointly-operated subsidiary,[9] River Road Marine Repair, Inc. If the bank wished to object to the consolidation, its counsel was present at the time of the consolidation order and should have objected at that time.

Second, the Meredosia Bank disagrees that the mortgage was to secure an antecedent debt. It is true that when a creditor takes and perfects security from an insolvent debtor, he does not receive a voidable preference if consideration was given by the creditor for the security in the form of a loan. 3 Collier on Bankruptcy ¶ 60.19 (14th ed. 1974). But here no new money was lent to the debtor. Rather, the mortgage was for an antecedent debt to the

[9] River Road Marine Repair, Inc.'s petition for consolidation described it as the wholly-owned subsidiary of Rasco's other corporation.

banks of $300,000 stemming from the check-kiting scheme. Appellant claims that the overdrafts permitted between September 10 and September 20, 1970, were allowed on the strength of the already negotiated and agreed upon but not yet issued mortgage. However, both the district judge's and our review of the record indicates that only when the bank examiners' investigation made it necessary to cover the banks' overdraft position did the banks and Rasco consider and approve the ship's mortgage." Therefore, the mortgage secured an antecedent debt.

Third, the bank argues that insufficient evidence was adduced at the hearing before the referee to support a finding of insolvency-in-fact at the time of the making of the mortgage. The appropriate definition of insolvency is given by Section 1(19) of the Bankruptcy Act (11 U.S.C. § 1(19)):

> "A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts."

The district judge outlined five excerpts from the record demonstrating insolvency under this standard:

> Mr. Rasco testified that at the time the mortgage was granted, the probability of bankrutcy had been discussed.
>
> Mr. Rasco testified that as of September 1, 1970, he believed that his liabilities were greater than his assets.
>
> Eugene Estes, a CPA, testified that both corporations were insolvent during September.
>
> William C. Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before "it broke."

[9] See, *e.g.*, Tr. Vol. 1 at 61-62 (Rasco); Vol. 2 at 200-203 (Rasco); Vol. 5 at 85, 87 (Chrisman, Director of the Meredosia Bank).

> Basil Humphrey, a CPA, testified that with hindsight the companies appeared to have been insolvent on October 1.

We agree with Judge Wood that the record demonstrates that the corporations were insolvent as of October 1, 1970, the date of the execution of the mortgage.

Accordingly, the requirements of Section 60(a)(1) were satisfied. The record shows[12] that at the time of the transfer the banks had "reasonable cause to believe that the debtor [was] insolvent" within the meaning of Section 60(b).[13] This preferential transfer was therefore voidable by the trustee, so that the proceeds from the sale of the vessels for some $45,000 are now available for the debtor's general creditors.

The bank has also raised some objections in the nature of affirmative defenses to the prima facie showing of voidable preference. It relies on the two-year statute of limitations contained in Section 11(e) of the Bankruptcy Act

---

[12] See text immediately preceding note 6 *supra*.

[13] Section 60(b) provides:

> "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

(11 U.S.C. § 29(e)).[14] That provision requires a trustee to sue on claims of the estate within two years of the bankruptcy adjudication. Thus appellant contends the trustee's voiding of the mortgage, even granted that it is a Section 60(a)(1) preference, is time barred. Section 11(e) is not applicable here where the trustee filed no suit on behalf of the debtor. Rather the lienholders asserted their claims against the trustee.[15] As the bankruptcy referee observed, Section 11(e) "does not come into play when [the trustee] defends money in his hands from creditors whose claims would be preferential if successful." The trustee's defense was in the nature of recoupment and therefore not barred by Section 11(e). Cf. *Bull v. United States,* 295 U.S. 247, 262.

The bank also complains of trial misconduct before the bankruptcy referee. While the trustee's witness, accountant Estes, may have related to the bank's witness, accountant Humphrey, that the bankruptcy referee had a pre-trial "problem of check-kiting" and of "unjust enrichment," that does not show that the referee had prejudged the case.

Nor can we fault the referee for casually remarking that the refusal of two subpoenaed witnesses, Ernest Thormahlen and Harold Westphal, to testify on Fifth Amendment grounds was because "there's something they don't want to tell." The Fifth Amendment provides that "[n]o person * * * shall be compelled in any criminal case to be a witness against *himself.*" (Emphasis supplied.) The Supreme Court has recently reminded us that:

"[d]espite its cherished position, the Fifth Amend-

---

[14] In pertinent part, Section 11(e) provides:

> "A * * * trustee may, within two years subsequent to the date of adjudication * * *, institute proceedings in behalf of the estate upon any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy."

[15] Of course, the trustee was not required to file a formal complaint to initiate the avoidance of the preference since the property in question was already within the bankruptcy court's jurisdiction. See 2 Collier on Bankruptcy ¶ 23.04(2) (14th ed. 1974).

> ment addresses only a relatively narrow scope of inquiries. Unless the Government seeks testimony that will subject its maker to criminal liability, the constitutional right to remain silent absent immunity does not arise. An individual therefore properly may be compelled to give testimony, for example, in a non-criminal investigation of himself." *Garner v. United States,* . . . U.S. . . ., 44 LW 4323, 4326.

The self-incrimination privilege is a personal one. Thus the banks *qua* corporations may not claim the privilege against self-incrimination—with its derivative mandate not to comment on a person's decision to claim the privilege and remain silent (*Griffin v. California,* 380 U.S. 609)—on behalf of Thormahlen and Westphal.

Of course, a civil penalty cannot be imposed upon a witness' exercise of the privilege. *Lefkowitz v. Turley,* 414 U.S. 70; *Garrity v. New Jersey,* 385 U.S. 493. Since Thormahlen and Westphal together own 60% of the stock of the Meredosia Bank (appellant's brief at 25), a colorable argument might be made that any adverse innuendo drawn by the referee concerning their failure to testify which would contribute to voiding the preference and thereby the reduction of the banks' priority in the bankrupt estate and, derivatively, a reduction of the property eventually to be distributed to the officers as stockholders is a penalty against these bank officers.

We are not impressed by this tortured logic. The quintessential nature of a corporation is the corporate veil drawn between it and its shareholders. To the extent that the above argument can be read as describing the imposition of a penalty on Thormahlen and Westphal for asserting the self-incrimination privilege, such a "penalty" is too attenuated to come within the stricture of the *Garrity* line of cases. In any event, since bankruptcy is a civil proceeding, the comment on the two officers' silence by the referee operated as an example of individuals being "compelled to give testimony • • • in a non-criminal investigation of [themselves]." *Garner, supra,* ... U.S. at ..., 44 LW at

4326. In addition, Thormahlen's and Westphal's wrongdoing as it impacted on the bankruptcy proceeding was firmly and independently established elsewhere in the record."

Finally, since the district court and the bankruptcy referee credited Assistant United States Attorney Pilolla's statement to the referee that there was no reference to grand jury testimony during the proceeding before the referee and no contrary showing has been made, as a reviewing court we cannot sustain the bank's claim that grand jury tax transcripts were unlawfully used by the trustee and should have been turned over to bank counsel for cross-examination use.

We conclude that the appellant was not entitled to the $45,000 proceeds of the sale of the vessels. Therefore, the district court's order of October 23, 1975, is affirmed.

A true Copy:

Teste:

.....

Clerk of the United States Court of Appeals for the Seventh Circuit

---

[16] See, *e.g.*, Trustee's Exhibits 1, 16; Bank's App. 138; Trustee's App. 3-5.